DEPARTMENT OF STATE REVENUE
LETTERS OF FINDINGS NUMBER: 07-0121, 07-0122
Adjusted Gross Income Tax
For the Taxable Years 2002-2004

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Adjusted Gross Income Tax – Business/Nonbusiness Income.

Authority: IC § 6-3-2-2; I.R.C. § 338.

Taxpayers protest the Department's allocation of nonbusiness income to Indiana.

STATEMENT OF FACTS

Taxpayer is a corporation engaged in the home medical care and respiratory care businesses. Taxpayer was wholly owned by Predecessor Parent. In 2002, Taxpayer's stock was transferred to Successor Parent. The transfer of stock was a taxable transaction for federal tax purposes.

Predecessor Parent and Successor Parent made an election under I.R.C. § 338(h)(10) to treat the gain from the transfer of Taxpayer's stock as a sale of Taxpayer's assets ("deemed asset gain"). Taxpayer originally reported the deemed asset gain as business income and paid corporate income tax based on the business-income treatment.

Later, Taxpayer filed an amended corporate income tax return. On the amended return, Taxpayer claimed that the deemed asset gain was nonbusiness income. Because the deemed asset gain was treated as nonbusiness income, only the deemed asset gain resulting from real and tangible personal property located in Indiana was allocated to Indiana. The deemed asset gain attributable to intangible assets was allocated to Taxpayer's claimed commercial domicile outside Indiana.

The amended return resulted in a refund claim by Taxpayer. The Indiana Department of Revenue ("Department") audited Taxpayer and agreed that the deemed asset gain constituted nonbusiness income. However, the Department determined that the deemed asset gain should have been allocated to Indiana based on Taxpayer's Indiana property factor. Thus, the Department assessed Taxpayer additional tax. Taxpayer protested the refund denial and assessment, a hearing was held with respect to the protest, and this Letter of Findings results.

Additional facts will be supplied as necessary. Any issues not specifically addressed in this Letter of Findings are considered to be resolved in a manner consistent with the Department's audited results.

I. **Adjusted Gross Income Tax** – Business/Nonbusiness Income.

DISCUSSION

This Letter of Findings should not be construed to represent that the Department would necessarily treat income derived from an I.R.C. § 338(h)(10) election as nonbusiness income in future assessments or protests. For purposes of this protest, the income from Taxpayer's deemed asset sale is treated as nonbusiness income due to the auditor's and Taxpayer's mutual treatment of the deemed asset sale income as nonbusiness income.

The Department determined that the allocation of a significant portion of Taxpayer's deemed asset gain to Taxpayer's domiciliary state did not fairly reflect Taxpayer's Indiana income. The Department sought to address the "fairly reflect" issue under IC § 6-3-2-2(l). The Department sought to "allocate" the deemed asset gain by attributing to Indiana the percentage of the deemed asset gain equal to Taxpayer's Indiana property to Taxpayer's property everywhere.

Under IC § 6-3-2-2(b), business income is apportioned by a three-factor formula, while nonbusiness income is allocated to the state from which the gain arises. Nonbusiness intangible income is generally sourced to the corporation's state of commercial domicile, while nonbusiness gains from real property and tangible personal property are allocated to the state in which the real property or tangible personal property is located. IC § 6-3-2-2(g)-(k). Taxpayer reported the deemed gains from Indiana real and personal property as nonbusiness income on its prior amended returns. The issue is whether Taxpayer's entire deemed asset gain should have been "allocated" based on Taxpayer's Indiana property factor.

In Taxpayer's case, a significant portion of Taxpayer's gains arose from intangible assets. While a significant portion of the intangible asset sale gains—particularly goodwill—arose from its Indiana customers and Indiana activities, IC § 6-3-2-2(g)-(k) impliedly allocates the gain to Taxpayer's domiciliary state if Taxpayer is domiciled outside Indiana. Taxpayer's domiciliary state is not Indiana. The Department's "allocation" of Taxpayer's nonbusiness income was improper, and thus Taxpayer's allocation of nonbusiness income per its amended corporate income tax return is sustained.

FINDING

Taxpayer's protest is sustained.

JR/BK/DK—September 10, 2007